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December 11, 2018

## VIA eFILING

Rosemary Chiavetta, Secretary  
Pennsylvania Public Utility Commission  
Commonwealth Keystone Building  
400 North Street  
Harrisburg, PA 17120

**Re: Pennsylvania Public Utility Commission v. Pennsylvania-American  
Water Company – Water Division  
Docket No. R-2018-3002502**

**Pennsylvania Public Utility Commission v. Pennsylvania-American  
Water Company – Wastewater Division  
Docket No. R-2018-3002504**

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Dear Secretary Chiavetta:

Enclosed for filing are the **Exceptions of Pennsylvania-American Water Company to the Recommended Decision of Administrative Law Judge Marta Guhl** (“Exceptions”) in the above-referenced matters.

As evidenced by the Certificate of Service, a copy of the Exceptions has been served upon Administrative Law Judge Marta Guhl and all parties of record. In addition, a copy of the Exceptions has been e-mailed to the Commission’s Office of Special Assistants.

Should you have any questions, please do not hesitate to contact me at 215.963.5034.

Very truly yours,



  
Anthony C. DeCusatis

c: Per Certificate of Service (w/encls.)  
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**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

<b>PENNSYLVANIA PUBLIC UTILITY COMMISSION</b>	:	
	:	
	:	
v.	:	<b>DOCKET NO. R-2018-3002502</b>
	:	
<b>PENNSYLVANIA-AMERICAN WATER COMPANY – WATER DIVISION</b>	:	
	:	
	:	
v.	:	<b>DOCKET NO. R-2018-3002504</b>
	:	
<b>PENNSYLVANIA-AMERICAN WATER COMPANY – WASTEWATER DIVISION</b>	:	

**CERTIFICATE OF SERVICE**

I hereby certify and affirm that I have this day served a copy of the **Exceptions of Pennsylvania-American Water Company** in the above-referenced proceedings on the following persons, in the manner specified below, in accordance with the requirements of 52 Pa. Code § 1.54:

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Respectfully submitted,



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Dated: December 11, 2018

**BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

<b>PENNSYLVANIA PUBLIC UTILITY COMMISSION</b>	:	
	:	
	:	
<b>v.</b>	:	<b>DOCKET NO. R-2018-3002502</b>
	:	
<b>PENNSYLVANIA-AMERICAN WATER COMPANY – WATER DIVISION</b>	:	
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	:	
<b>PENNSYLVANIA PUBLIC UTILITY COMMISSION</b>	:	
	:	
	:	
<b>v.</b>	:	<b>DOCKET NO. R-2018-3002504</b>
	:	
<b>PENNSYLVANIA-AMERICAN WATER COMPANY – WASTEWATER DIVISION</b>	:	

**EXCEPTIONS OF  
PENNSYLVANIA-AMERICAN WATER COMPANY  
TO THE  
RECOMMENDED DECISION OF ADMINISTRATIVE LAW JUDGE MARTA GUHL**

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Dated: December 11, 2018

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## I. INTRODUCTION

The Tax Cuts and Jobs Act<sup>1</sup> (“TCJA”) has increased the overall cost of connecting new customers to the water and wastewater systems of Pennsylvania-American Water Company (“PAWC” or the “Company”) by making customer advances for construction, customer contributions in aid of construction and customer deposits for construction (collectively, “Contributions and Advances”) taxable income.<sup>2</sup>

To clarify how taxable Contributions and Advances would be handled, on June 5, 2018, PAWC filed Supplement No. 6 to Tariff Water-Pa. P.U.C. No. 5 (“Supplement No. 6 Water”) and Supplement No. 6 to Tariff Wastewater-Pa. P.U.C. No. 16 (“Supplement No. 6 Wastewater”) with the Pennsylvania Public Utility Commission (“Commission” or “PUC”). Both Supplements reflect the Company’s proposal to adopt the “no gross-up” method for Contributions and Advances. Under the “no gross-up” approach, Contributions and Advances paid by an applicant would not be increased (or “grossed-up”) for the Federal and state income taxes payable on those amounts (a full gross-up) or for the time-value of money difference between the tax payable by the Company upon receipt of a contribution or advance and the future depreciation deductions it will receive with respect to the property funded by the contributions or advance. A detailed procedural history is provided in the Company’s Main Brief filed on November 5, 2018. The Company also filed a Reply Brief on November 15, 2018.

On December 5, 2018, the Recommended Decision of Administrative Law Judge Marta Guhl (the “ALJ”) was issued. The ALJ recommended rejecting the Company’s proposal and requiring PAWC to utilize a gross-up methodology for Contributions and Advances. As explained hereafter, the Recommended Decision erred in concluding that a nearly 30-year-old

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<sup>1</sup> Tax Cuts and Jobs Act, Pub. L. No. 115-97 (2017).

<sup>2</sup> Because the Pennsylvania Corporate Net Income Tax is based on Federal taxable income, the change in Federal tax law made Contributions and Advances taxable income for Pennsylvania corporate income tax purposes as well.

industry analysis should be applied today despite notable changes in competitive circumstances and industry preferences. The Recommended Decision also erred in finding that the Company had a burden to show that a gross-up methodology would discourage the addition of new customers. The evidence in the proceeding shows that PAWC's proposal to implement the no gross-up method for Contributions and Advances is just and reasonable, will result in a net benefit to existing customers, and is consistent with industry preferences.

## II. EXCEPTIONS

The Company respectfully takes the following Exceptions to the Recommended Decision:

**Exception No. 1. The Recommended Decision Errs In Finding That The PUC's TRA-86 Order Should Be Deemed To Continue To Apply To Water And Wastewater Utilities While Failing To Address The PUC's Prior – And Continuing – Approval Of The Use Of The No Gross-Up Method For Gas Distribution Companies Notwithstanding The Deregulation Of The Gas Industry. (R.D., pp. 29-30)**

Exception is taken to the ALJ's recommendation that the Commission rely upon a nearly 30-year-old market analysis to support the application of a gross-up methodology for water and wastewater Contributions and Advances. Undeniable changes to industry preferences and competitive position, and the Commission's continued acceptance of the no gross-up methodology for gas utilities, warrant a new analysis of the appropriate treatment of Contributions and Advances for water and wastewater utilities.

**Exception No. 2. The Recommended Decision Errs In Finding That The No Gross-Up Method Would Not Be Just And Reasonable, Would Improperly Impose The Costs Of Serving New Customers On Existing Customers Or Would Produce A Subsidy To New Customers By Existing Customers. (R.D., pp. 29-32)**

Exception is taken to the ALJ's recommendation that the Commission find that the Company has the burden to prove that the gross-up method would discourage developers.

PAWC need only show that its no gross-up proposal is just and reasonable and the Company has provided undisputed evidence that existing customers will benefit from the addition of a new customer under the no gross-up methodology.

**Exception No. 3. The Recommended Decision Errs In Finding That Imposing A Gross-Up Method On Water And Wastewater Utilities Is Necessary To Maintain “Consistency And Uniformity” And To Discourage “Territory Shopping.” (R.D., p. 30).**

Exception is taken to the ALJ’s recommendation that the Commission find that a gross-up methodology will provide needed consistency and uniformity in the industry and eliminate the issue of territory shopping. Implementing a gross-up methodology could encourage territory shopping by creating an advantage for municipal water and wastewater providers and is inconsistent with the preferences of the overall water/wastewater industry.

**Exception No. 4. The Recommended Decision Errs In Finding That Wastewater Capacity Reservation Fees Should Be Subject To Gross Up. (R.D., p. 31).**

Exception is taken to the ALJ’s recommendation that the Commission find that the Company has the burden to prove that grossing up Capacity Reservation Fees will decrease the number of potential wastewater customers. The Company has provided substantial evidence that the Capacity Reservation Fees are substantively different from traditional Contributions and Advances and the payment of Capacity Reservation Fees without a gross-up will still provide a significant benefit to existing customers.

### III. ARGUMENT

#### A. **The Recommended Decision Errs In Finding That The PUC’s TRA-86 Order Should Be Deemed To Continue To Apply To Water And Wastewater Utilities While Failing To Address The PUC’s Prior – And Continuing – Approval Of The Use Of The No Gross-Up Method For Gas Distribution Companies Notwithstanding The Deregulation Of The Gas Industry (Exception No. 1)**

The Commission addressed the appropriate treatment of taxes on Contributions and Advances in an Order that followed the Tax Reform Act of 1986 (the “TRA-86 Order”).<sup>3</sup> Different utility types were separately analyzed in the TRA-86 Order, and the Commission did not approve the same methodology for each type of utility service. Gas utilities, for example, were permitted to use the no gross-up method for Contributions and Advances. Water and wastewater utilities, however, were required to select one of three gross-up methodologies for Contributions and Advances.<sup>4</sup>

In determining the appropriate methodology for Contributions and Advances, the Commission considered the preferences and competitive circumstances of each utility sector. The TRA-86 Order states that the “great majority” of water companies participating in the TRA-86 proceeding “preferred the use of a gross-up methodology” while “most” gas utilities favored a no gross-up method.<sup>5</sup> Regarding competitive circumstances, the Commission focused on the differences between utility sectors. At that time, gas utilities were subject to competitive forces related to alternatives to use of the natural gas commodity they sold. The Commission found

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<sup>3</sup> *Re Contributions in Aid of Construction and Customer Advances*, Docket No. I-880083, 70 Pa. P.U.C. 44, (Order entered June 14, 1989) (the “TRA-86 Order”).

<sup>4</sup> The TRA-86 Order also provided that a water or wastewater utility could seek Commission approval to depart from the three gross-up methodologies. Several months following the TRA-86 Order, the Commission approved the no gross-up method for use by PAWC with respect to Contributions and Advances from government entities. *See Pa. P.U.C. v. Pennsylvania-American Water Co.*, Docket No. P-890376 (Order entered Nov. 3, 1989) (the “PAWC TRA-86 Order”). A copy of the PAWC TRA-86 Order has been provided as PAWC Exhibit No. 4.

<sup>5</sup> TRA-86 Order, pp. 50, 57.

that competitive forces for water and wastewater were less significant: “competition within the industry is not as vital a force as it is in the energy based [electric and gas] industries.”<sup>6</sup>

Since the TRA-86 Order, there have been significant changes to both industry preferences and competitive circumstances that were relied upon by the Commission to justify different methodologies for the water/wastewater and natural gas utility sectors. First, the largest water and wastewater providers in Pennsylvania now support a no gross-up methodology.<sup>7</sup>

Second, as a result of restructuring in 1999, gas utilities are no longer sellers of natural gas.<sup>8</sup> Gas utilities only furnish distribution service (and supplier-of-last resort service, which is simply a pass-through, not a profit center and not a “competitive” service). Therefore, they no longer face the “competitive forces” the Commission relied upon in the TRA-86 Order. In addition, the availability of abundant low-cost Marcellus shale gas has changed the market dynamics for heating fuel. For new construction, potential home buyers may view natural gas as a necessary heating source given its current low cost and its low cost relative to the alternatives.<sup>9</sup>

Third, the water industry in Pennsylvania is now experiencing significant competitive forces as municipally-owned water systems, which are not subject to either income tax or the Commission’s jurisdiction, have become increasingly aggressive in challenging PUC-jurisdictional water utilities’ efforts to serve areas of demonstrated public need for water service. In most instances, municipalities’ attempts to curtail PUC-jurisdictional water utilities’ service to

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<sup>6</sup> See TRA-86 Order, p. 57.

<sup>7</sup> In addition to PAWC, Aqua Pennsylvania, Inc. has proposed a no gross-up methodology as part of its ongoing base rate proceeding at Docket No. R-2018-3003558, et al. The York Water Company (“York”) already has a no gross-up methodology embedded in its tariff. See York Tariff Water-Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction. In addition, by its Final Order entered December 6, 2018 at Docket No. R-2018-3000834, the Commission approved a Joint Petition for Approval of Settlement of Rate Proceeding for Suez Water Pennsylvania (“Suez”) that included a term providing that, following the resolution of this proceeding, Suez would file a tariff supplement conforming to the Commission’s Order in this case.

<sup>8</sup> 66 Pa.C.S. § 2204(a) (implementing customer choice for retail customers of natural gas distribution companies).

<sup>9</sup> See PAWC St. No. 1, p. 7; PAWC St. No. 1-R, pp. 3-4.

new customers and new areas is based on claims that they can supply service at lower cost because they are not burdened with the payment of income (or other) taxes and can finance their operations with tax-free debt. Indeed, over the last approximately twenty years, the Commission and Pennsylvania appellate courts have had to adjudicate an increasing number of protests and complaints by municipalities seeking to compete directly with PUC-jurisdictional water utilities.<sup>10</sup>

Notably, although the heightened competitive concerns in the gas industry cited by the Commission in its TRA-86 Order no longer exist, it has continued to allow gas utilities to utilize the no gross-up method for the last nearly 20 years.<sup>11</sup> The Commission's continued acceptance of the no gross-up method by gas utilities indicates, contrary to the position of the ALJ, that the Commission has now recognized its merit. It is also indicative of the fact that the Commission's decision in the TRA-86 Order gave material weight to each industry's expressed preference, since the majority of gas industry commenters in that proceeding favored the no gross-up method. Moreover, the Company discussed in detail the Commission's acceptance of the no gross-up method for gas utilities in its verified responses to the Commission's data requests in the TCJA proceeding at Docket No. M-2018-2641242,<sup>12</sup> where it set forth its proposal and

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<sup>10</sup> *Chester Water Auth. v. Pa. P.U.C.*, 581 Pa. 640, 868 A.2d 384 (2005) (affirming the PUC's decision to grant a certificate of public convenience to a PUC-jurisdictional water utility to serve an area of demonstrated need over the protest of municipal authority seeking to compete with the utility); *Mun. Auth. of the Borough of West View v. Pa. P.U.C.*, 41 A.3d 929 (Pa. Cmwlth. 2012) (affirming a PUC decision dismissing a municipal authority's complaint challenging a utility's right to serve a new resale customer based on claims of unfair competition); *Mun. Auth. of the Twp. of Robinson v. Pennsylvania-American Water Co.*, Docket No. C-20030092 (Aug. 1, 2004) (dismissing a municipal authority's complaint challenging the utility's right to serve a new customer based on claims, *inter alia*, of unfair competition), *aff'd by Mun. Auth. of the Twp. of Robinson v. Pa. P.U.C.*, No. 2008 C.D. 2004 (Pa. Cmwlth. 2005) (unreported decision); *Application of Phila. Sub. Water Co. for Approval to Begin to Offer, Render, Furnish and Supply Water Serv. to the Pub. in a Portion of Thornbury Twp., Delaware Cnty., Pennsylvania*, Docket No. A-212370F0059, 2001 Pa. PUC LEXIS 8 (Jun. 21, 2001) (granting a certificate of public convenience to a PUC-jurisdictional water utility to serve an area of demonstrated need over the protest of municipal authority seeking to compete with the utility).

<sup>11</sup> See, e.g., Columbia Gas of Pennsylvania, Inc. Tariff Gas – Pa. P.U.C. No 9, Rule 8.2.5 Taxes on Deposits for Construction & Customer Advances, page 49a.

<sup>12</sup> See PAWC Main Br., pp. 1-2; PAWC St. No. 1-R, pp. 6-7.

explained why it was reasonable. While the Commission issued both a generic and utility-specific orders in the TCJA proceeding providing detailed instructions for reflecting other changes in the tax law made by the TCJA, it did not express any concerns about the Company's proposal to adopt the no gross-up method (or similar proposals by other water utilities).<sup>13</sup> Similarly, the Commission did not express any concerns in the TCJA proceeding about York's existing tariff provision which adopts the no gross-up method.<sup>14</sup>

In urging the Commission to rely on the industry-specific analysis completed almost 30 years ago in the TRA-86 Order, the ALJ concluded there was "no evidence" that the water/wastewater industry changes warranted the no gross-up method.<sup>15</sup> However, the ALJ did not address the Company's evidence concerning competition between municipal and investor-owned water and wastewater utilities under a gross-up methodology, which is described above and discussed further in Section III.B *infra*, or the changes in the natural gas sector and the Commission's continued approval of the no gross-up method for that sector.<sup>16</sup> The Company submits that the undeniable changes to industry preferences and competitive positions warrant a new analysis of the appropriate treatment of Contributions and Advances. Other jurisdictions, such as New York, have recently engaged in such an analysis. Similar to the Commission, the New York Public Service Commission ("NY PSC") required a gross-up for water utility Contributions and Advances when they were made taxable under TRA-86. After the passage of the TCJA, the NYC PSC determined that it was appropriate to consider how facts and circumstances have changed in the last 30 years. The NY PSC ultimately concluded that the no

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<sup>13</sup> *Id.*

<sup>14</sup> See York Tariff Water-Pa. P.U.C. No. 14, Rule 3.11.8, Taxes on Deposits for Construction.

<sup>15</sup> R.D., pp. 29-30.

<sup>16</sup> *Id.*

gross-up method should be mandatory for larger water utilities unless a utility could show the method would have a significant adverse effect on its finances or customers.<sup>17</sup>

**B. The Recommended Decision Errs In Finding That The No Gross-Up Method Would Not Be Just And Reasonable, Would Improperly Impose The Costs Of Serving New Customers On Existing Customers Or Would Produce A Subsidy To New Customers By Existing Customers (Exception No. 2)**

The Company has presented evidence in this proceeding that its proposal will provide a net benefit for customers.<sup>18</sup> Existing customers would not subsidize developers or new customers if the no gross-up method is employed; in fact, new customers produce a significant benefit, as PAWC witness John R. Cox explained:

As shown on PAWC Exhibit No. 5, a new average residential water customer provides net revenue sufficient to fund \$4,839 in rate base. Under the applicable provisions of the Company's water tariff, the Company's investment in the facility extension that might be needed to add that customer would be \$2,632. The net benefit to the Company and its existing customers is \$2,797, which includes the effect of the depreciation deductions on the new plant funded by CAC/CIAC. Based on that amount, the Company and its existing customer could receive up to \$9,681 in contributed property and absorb the income taxes on that amount and still break-even. Any contribution less than that amount is a net benefit to the Company and its existing customers, because existing fixed costs that otherwise would be borne by existing customer are spread over a larger customer base, and the new customers are paying a level of fixed costs that exceeds the amount of rate base installed to serve them.<sup>19</sup>

As Mr. Cox also explained, for wastewater customers, the benefit is even larger because the Company does not fund any portion of the facility extension for non-bona-fide applicants.<sup>20</sup>

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<sup>17</sup> See *Proceeding on Motion of the Comm'n on Changes in Law that May Affect Rates*, Case No. 17-M-0815 (Order issued Aug. 9, 2018), pp. 32-33.

<sup>18</sup> See PAWC Main Br., pp. 8-9; PAWC Reply Br., pp. 2-3; *see also* R.D., p. 12.

<sup>19</sup> PAWC St. No. 1, p. 8.

<sup>20</sup> *Id.*

The ALJ does not dispute that existing customers benefit from the addition of new customers, but recommends that a gross-up method be imposed regardless because the added cost of the gross-up method will not be a “deterrent” to developers’ constructing, or customers buying, new homes.<sup>21</sup> In short, the ALJ found that the gross-up method should be adopted unless PAWC can prove that the gross-up method will result in fewer homes being built – with a correspondingly lower level of the overall benefits identified by the Company.

PAWC does not have the burden to produce evidence that the gross-up method would be a “deterrent” to developers constructing, and new customers buying, new homes. The issue is justness and reasonableness of the rate – i.e., the Contribution or Advance<sup>22</sup> – that will be charged to applicants requesting extensions of the Company’s facilities. The Company need only show that its proposal is “just and reasonable.” And, in applying that standard, the Commission must consider the *total effect* of the rate at issue.<sup>23</sup> The evidence in this proceeding shows that the overall effect of the Company’s proposal will properly compensate the Company and its existing customers for the costs associated with extending facilities to serve new customers and, in fact, will likely produce substantial overall benefits to existing customers.

**C. The Recommended Decision Errs In Finding That Adoption Of A Gross-Up Method Would Achieve Uniformity And Eliminate Territory Shopping (Exception No. 3)**

The ALJ recommends that the Commission find that a gross-up methodology will provide needed “consistency and uniformity” in the industry and eliminate the issue of “territory

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<sup>21</sup> R.D., pp. 30-31 (“[T]here is nothing in the record to show that the Company would not be able to add new customers if the gross-up method is used.”).

<sup>22</sup> Contributions and Advances are clearly within the definition of a “rate” set forth in 66 Pa.C.S. § 102.

<sup>23</sup> *McCloskey v. Pa. P.U.C.*, 127 A.3d 860, 868 (Pa. Cmwlth. 2015)(“The United States Supreme Court in *Duquesne Light Company* acknowledged that there were many ways to achieve rates that were just and reasonable, and went on to find that the disallowance of a single element was not the appropriate standard for determining whether rates were just and reasonable; however, a determination regarding whether rates were just and reasonable must involve a look at the total effect of the rates.”) citing *Duquesne Light Co. v. Barasch*, 448 U.S. 299 (1989).

shopping.”<sup>24</sup> Consistency and uniformity, however, can be achieved by authorizing the no gross-up method for all water and wastewater utilities. All major water and wastewater utilities favor no gross-up of Contributions and Advances and, as discussed earlier, the Commission considered the opinions of the utilities in determining the appropriate method to utilize in the TRA-86 Order.

Adopting the ALJ’s recommendation would not produce “consistency and uniformity” because municipal water and wastewater providers do not pay income tax and, therefore, do not gross-up any Contributions or Advances. If a gross-up methodology is adopted as the ALJ recommends, municipal providers will be given an even greater advantage than they already enjoy, and “territory shopping” – to the detriment of PUC-jurisdictional water and wastewater utilities – would undoubtedly occur.<sup>25</sup> Indeed, industry experience since the issuance of the TRA-86 Order clearly shows that there is substantially heightened competition between PUC-jurisdictional water utilities and municipally-owned systems as the latter have ratcheted-up their efforts to compete with investor-owned water suppliers. The no gross-up method would at least level the playing field for investor-owned water and wastewater utilities when faced with municipal systems that do not pay income (or any other tax) and can finance their operations with tax-favored debt.

Finally, adopting the ALJ’s proposal would not create “consistency and uniformity” among investor-owned utilities. For a single development, a developer could end up paying a gross-up for water infrastructure and no gross-up for gas infrastructure.<sup>26</sup>

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<sup>24</sup> R.D., p. 30.

<sup>25</sup> PAWC Reply Br., p. 6.

<sup>26</sup> *Id.*

**D. The Recommended Decision Errs In Finding That Wastewater Capacity Reservation Fees Should Be Subject To Gross Up (Exception No. 4)**

The Company has provided evidence in this proceeding that Capacity Reservation Fees are materially different from traditional Contributions and Advances. Although booked as contributions, Capacity Reservation Fees do not result in any new expenditure or newly-incurred cost for the Company in contrast to what occurs when a main extension must be made to serve new customers. Applicants pay such fees to reserve wastewater treatment capacity on the Company's system. The Capacity Reservation Fees directly benefit existing customers by reducing the amount of revenue requirement existing customers would otherwise have to bear.<sup>27</sup>

In finding that wastewater Capacity Reservation Fees should be subject to gross up, the ALJ again applies an improper "deterrent" standard. Specifically, the ALJ cites the assertion by the Commission's Bureau of Investigation and Enforcement ("I&E") that "the record is devoid of evidence that charging the tax associated with Capacity Reservation Fees will decrease the number of potential wastewater customers."<sup>28</sup> The appropriate standard is whether the Company's proposal is "just and reasonable," and, the evidence in this proceeding shows the direct benefits that Capacity Reservation Fees provide to existing customers under a no gross-up methodology.

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<sup>27</sup> PAWC St. No. 1, pp. 8-9; PAWC St. No. 1-R, p. 6.

<sup>28</sup> R.D., p. 31.

#### IV. CONCLUSION

For the reasons set forth above and in PAWC's Main and Reply Briefs, the Company's Exceptions should be granted and the ALJ's recommendation to require PAWC to gross up Contributions and Advances should be rejected. The Commission should enter an Order approving PAWC's Supplement No. 6 Water and Supplement No. 6 Wastewater and permitting the Company to utilize the no gross-up method for Contributions and Advances.

Respectfully submitted,



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